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Customer Deposits: Tax-Free Security or Prepaid Income?

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CUSTOMER DEPOSITS: TAX-FREE SECURITY OR PREPAID INCOME?

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I. INTRODUCTION

Deposits made by lessees or customers in connection with the future use of property or the receipt of services are commonplace, but their use is not without some tax risk. Although the term "deposit" suggests that monies have been received subject to an offsetting obligation to repay, and therefore, are not included in the recipient's

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income, such payments often exhibit many of the characteristics associated with prepaid income. Courts have struggled with the definition of gross income since the early days of the federal income tax, but they have yet to develop a clear test for determining if and when recipients must include such deposits in gross income.

A split of authority has developed between the Seventh and Eleventh Circuits regarding the tax treatment of customer deposits received by utility companies as security for the payment of future utility bills. In *City Gas Co. of Florida v. Commissioner*,[1] the Eleventh Circuit required the application of a test which the Tax Court used on remand to require inclusion of deposits in income on receipt.[2] On similar facts, the Seventh Circuit in *Indianapolis Power & Light Co. v. Commissioner*[3] reached the opposite conclusion. These disparate results prompted the Supreme Court to grant the government's petition for writ of certiorari in *Indianapolis Power & Light*.[4] With the Supreme Court's decision to hear this case comes renewed debate over the tax treatment of customer deposits.

This article first discusses the decisions in *City Gas* and *Indianapolis Power & Light*. The body of case law dealing with the taxation of rental deposits is then reviewed to set the stage for an analysis and comparison of the *City Gas* and *Indianapolis Power & Light* decisions. Finally, this article explores the concept of gross income in connection with the receipt of customer deposits and offers alternative analytical approaches for characterizing deposits as either prepaid income or nontaxable security deposits in an attempt to provide a logical means of treating customer deposits for federal income tax purposes.

II. Historical Background

A. *The Utility Deposit Cases*

Confusion over the proper characterization of utility customer deposits for tax purposes began with the Tax Court's decision in *City Gas*.[5] *City Gas* involved a regulated public utility company, City Gas Company of Florida, and its two unregulated subsidiaries, Dade Gas Company and Dri-Gas Corporation.[6] All three companies were accrual-

1. 689 F.2d 943 (11th Cir. 1982).
2. *Id.* at 948.
3. 857 F.2d 1162 (7th Cir. 1988), *cert. granted*, 109 S. Ct. 1929 (1989).
4. Commissioner v. Indianapolis Power & Light Co., 109 S. Ct. 1929 (1989).
5. City Gas Co. v. Commissioner, 74 T.C. 386 (1980), *rev'd*, 689 F.2d 943 (11th Cir. 1982).
6. *Id.* at 367.

method taxpayers engaged in the business of selling natural gas or propane to residential and commercial customers.[7] The companies required their customers to make a cash deposit to establish a new account.[8] The receipt issued by each company stated that the company held the deposit to secure payment of all bills for services rendered to the customer.[9] The receipt also indicated that upon termination of service or prior election by the company, the deposit would be returned to the customer after deducting any amounts then owed to the company. Each of the companies followed the same procedure when a customer terminated service: the final bill was prepared, the customer's deposit was applied against the balance due, and any excess was refunded to the customer.[10] If a balance due existed after application of the deposit, the companies sent a bill for the difference to the customer for payment.[11] Unclaimed deposits eventually escheated to the State of Florida.[12]

The Florida Public Service Commission required regulated public utilities to pay interest on customer deposits.[13] City Gas paid interest at the minimum prescribed rate of four percent.[14] The two unregulated subsidiaries chose not to pay interest on deposits.[15] Customer deposits held by each of the companies were not physically segregated from general operating funds, and the companies' use of these funds was not restricted.[16]

In accordance with its system of accounting,[17] City Gas treated customer deposits as current liabilities for financial reporting purposes.[18] Dade Gas and Dri-Gas also reported deposits received as current liabilities.[19] All three companies treated customer deposits as liabilities for federal income tax purposes.[20] The Internal Revenue Service challenged the treatment of customer deposits as current

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7. *Id.*
8. *Id.* at 388.
9. *Id.*
10. *Id.* at 389.
11. *Id.*
12. *Id.* at 389.
13. *Id.* at 388.
14. *Id.* at 389.
15. *Id.*
16. *Id.*
17. As a regulated utility, City Gas was prescribed to use the National Association of Regulatory Commissioners Uniform System of Accounts. *Id.* at 388.
18. *Id.*
19. *Id.* at 389.
20. *Id.*

liabilities, arguing that the deposits represented advance payments required to be included in gross income on receipt.[21]

In its initial opinion, the Tax Court reviewed "the totality of the facts and circumstances" and concluded that the customer payments were nontaxable security deposits.[22] The court focused on the taxpayers' acknowledged obligation to account for each customer's deposit, an obligation which the court concluded could only be satisfied by refunding the deposit or applying it to the customer's unpaid bill.[23] The court also cited treatment of customer deposits as liabilities for tax and financial reporting purposes, payment of interest on customer deposits, and escheat of unclaimed deposits to the state as factors supporting its decision.[24]

A series of rental deposit cases cited by the Service in support of its position failed to persuade the court that City Gas and its subsidiaries should include customer deposits in income upon receipt.[25] The court distinguished this line of cases by noting that in each, the taxpayer's right to apply deposits against the lessee's fixed future rent obligation — a right which the courts likened to unrestricted control over deposits received — justified the decision to require immediate inclusion in income.[26] Given the companies' inability to determine in advance the amount of a customer's final bill, the court concluded that City Gas and its subsidiaries did not have the right to apply customer deposits in payment of *fixed* future obligations and, therefore, did not have the unrestricted control over deposits necessary to justify immediate inclusion in gross income.[27]

On appeal, the Eleventh Circuit reversed the Tax Court decision.[28] The court began its review of the case by noting that gross income includes payments received for goods, services or other income items if the recipient has a present right to such payments and has complete

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21. *Id.* at 390.

22. *Id.* at 391. The court reached this conclusion only after initially noting that tax-free treatment of security deposits was an exception to the general rule requiring inclusion in gross income of "[a]dvance payments to which a taxpayer recipient has a present right, and over which he has unrestricted control . . . ." *Id.* On appeal, the Eleventh Circuit relied on this general rule to reverse the decision of the Tax Court in *City Gas*. *See City Gas Co.*, 689 F.2d at 945.

23. *City Gas*, 74 T.C. at 392.

24. *Id.* at 392-93.

25. For a discussion of these rental deposit cases, see *infra* notes 74-124 and accompanying text.

26. *City Gas*, 74 T.C. at 392.

27. *Id.*

28. *City Gas Co.*, 689 F.2d at 943.

and unrestricted control over their use and disposition.[29] The court then compared the tax treatment of these "advance payments" to the tax-free status of refundable "security deposits" offered to secure property against loss or damage or to secure the performance of conditions or other nonincome-producing covenants of a contract.[30] Based on its review of these two rules, the court concluded that customer deposits received by City Gas and its subsidiaries would be considered taxable advance payments if the companies held the sums deposited as security for the payment of income items rather than as security for the performance of nonincome-producing covenants.[31] Recognizing that many deposits would have a mixed purpose, the Court concluded, "the test to be applied in this case is whether, under all the circumstances, the primary purpose of the payments at issue was a prepayment of income items, or whether the primary purpose was to secure the performance of nonincome-producing covenants."[32]

The Eleventh Circuit criticized the Tax Court for basing its decision in part on the taxpayer's consistent treatment of customer deposits for tax and financial reporting purposes.[33] It also challenged the lower court's conclusion that the rental deposit cases cited by the Commissioner could not be applied to utility deposit cases in the absence of an obligation to make a fixed future payment.[34] The Eleventh Circuit remanded the case to the Tax Court with instructions to apply the "primary purpose test."[35]

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29. *Id.* at 945.

30. *Id.* at 946.

31. *Id.* Before framing the issue, the court observed that two of the three requirements necessary for treatment of the deposits as an advance payment — a present right to income and unrestricted control over the amounts received — had been met. *Id.* While the taxpayers' level of control over customer deposits was undisputed, City Gas did challenge the government's position that the utilities had a present right to income upon receipt of a deposit. In footnote 10 of the opinion, the court concluded that as soon as the gas was turned on, the customer had an obligation to pay, and this obligation left the taxpayers with a "continuing 'present right'" to income. *Id.* at 950 n.10.

32. *Id.* at 948.

33. *Id.* at 949. The court noted that a method of accounting imposed by a regulatory agency will not be respected for tax purposes if it does not result in a clear reflection of income. *Id.* (citing Commissioner v. Idaho Power Co., 418 U.S. 1, 15 (1974)). For a discussion of the significance of a taxpayer's method of accounting, see *infra* notes 161-63 and accompanying text.

34. *City Gas Co.*, 689 F.2d at 949. The Eleventh Circuit took the position that the rental cases cited by the Commissioner were premised on the theory that a deposit is taxable if its purpose is to prepay rent. Since no fixed future payment would be required under this approach, the court concluded that the Tax Court's concern over its inability to determine at the outset the taxpayer's interest in the deposit was misplaced. *Id.* at 949.

35. *Id.* at 950.

On remand, the Tax Court found that, in most cases, the companies expected and intended to evantually apply the deposits to charges for gas consumed by the customer.[36] Because the most significant charge on a customer's final bill was for gas consumed, and because the companies usually applied the deposits against the customer's final bill, the Tax Court held that the primary purpose of each deposit was to act as a prepayment of the customer's final gas bill.[37] Having determined that these customer deposits were held as security for the future payment of income items, the Tax Court characterized them as advance payments and required the taxpayers to include them in income in the year of receipt.[38]

Indianapolis Power & Light also involved the collection of customer deposits by a regulated public utility. The taxpayer in *Indianapolis Power & Light* was an accrual-method taxpayer engaged in the business of generating, transmitting, distributing, and selling electrical energy.[39] When a customer established a new account, the company evaluated the customer's creditworthiness.[40] The company required deposits of all customers who failed to meet its minimum credit standards.[41] Upon receiving a deposit, the company issued a receipt stating that it would hold the deposit to ensure prompt payment of the customer's bills and that the deposit would be refunded after service had been disconnected and all bills had been paid.[42] In practice, the company usually credited the customer's final bill with the amount of the deposit.[43]

The company also refunded customer deposits at the request of any customer who could meet the company's creditworthiness standards at the time of the request.[44] When faced with such a refund

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36. City Gas Co. v. Commissioner, 47 T.C.M. (CCH) 971, 973 (1984).

37. *Id.*

38. *Id.* In response to the taxpayers' argument that their primary purpose was not to collect advance payments but to minimize collection losses and provide security for accounts receivable, the Tax Court concluded that if the prepayments were not categorized as security for the performance of nonincome-producing covenants, they would fall within the only other category announced by the appeals court and would be taxable: "The Eleventh Circuit, as we understand it, did not admit of the possibility of other categories." *Id.* (citing *City Gas Co.*, 689 F.2d at 948 n.7). For a discussion of the Eleventh Circuit's footnote 7, see *infra* note 143.

39. Indianapolis Power & Light Co. v. Commissioner, 88 T.C. 964, 965 (1987), *aff'd*, 857 F.2d 1162 (7th Cir. 1988), *cert. granted*, 109 S. Ct. 1929 (1989).

40. *Id.* at 966.

41. *Id.*

42. *Id.*

43. *See id.* at 968.

44. *Id.* at 967.

request, the company asked the customer how the deposit should be refunded. Most customers requested a cash refund, but occasionally the company was asked to apply the deposit as a credit to the customer's utility bill.[45] A subsequent amendment to the rules issued by the Public Service Commission of Indiana required regulated public utilities to refund a customer's deposit automatically after a review of the customer's recent payment history had established that customer's creditworthiness.[46] Indianapolis Power & Light, a regulated public utility, complied with this rule and issued refunds accordingly. Customers continued to determine the manner in which they received refunds under this new procedure.[47]

The Public Service Commission of Indiana required Indianapolis Power & Light to adopt a standardized method of accounting for financial reporting purposes.[48] Consistent with that method of accounting, the company treated customer deposits as current liabilities.[49] The company also treated deposits as current liabilities for federal income tax purposes.[50] Additionally, the Commission required the company to pay interest at the rate of six percent on customer deposits held more than one year.[51] The company did not physically segregate customer deposits from general operating funds, nor was its use of the funds restricted.[52] Unclaimed deposits ultimately escheated to the State of Indiana.

In a unanimous reviewed decision, the Tax Court rejected the Eleventh Circuit's "primary purpose" test and the applicability of the rental deposit cases cited in support of the Eleventh Circuit's approach and instead chose to focus on the rights retained by the depositor and those acquired by the holder of the deposit through an examination of all the facts and circumstances.[53]

The court first noted that only five percent of the company's customers actually were required to post deposits, a fact which suggested that the company's objective was not to maximize prepaid income

45. *Id.*

46. *Id.* at 967-68. Specifically, the amended rules required the company to refund residential customer deposits after the customer made satisfactory payments during a period of nine consecutive months or in any ten months falling within a twelve-month period. *Id.*

47. *Id.* at 968.

48. *Id.* at 969.

49. *Id.* at 968.

50. *Id.*

51. *Id.* at 967.

52. *Id.* at 968.

53. *Id.* at 976.

through the use of deposits.[54] The court also observed that depositors retained substantial control over the ultimate disposition of their deposits and that the company could use a customer's deposit only when utility bills were not paid.[55] Finally, the payment of interest on deposits and the taxpayer's consistent treatment of deposits as liabilities, both for income tax and financial reporting purposes, suggested that the company had treated deposits as the property of its customers.[56] These facts convinced the Tax Court that the deposits received were not intended as advance payments of income. The court concluded that the company held customer deposits temporarily as security for the future payment of utility bills. Thus, the court did not require the company to include such deposits in income.[57]

On appeal, the Seventh Circuit affirmed the decision of the Tax Court in *Indianapolis Power & Light*.[58] The court began its review of the case by summarizing the Eleventh Circuit's approach in *City Gas*.[59] The Seventh Circuit agreed that the primary purpose test was the most appropriate method of determining the tax treatment of customer deposits,[60] but refused to fully endorse the Eleventh Circuit's application of the primary purpose test in *City Gas*.[61] After criticizing the Eleventh Circuit for limiting the scope of tax-free security deposits to payments held as security for nonincome-producing covenants, the court concluded that application of the primary purpose test need not always result in the taxation of deposits held to secure the future payment of income items.[62] The Seventh Circuit held that an examination of all the facts and circumstances was necessary to determine whether the primary purpose of such a deposit was to prepay income or to secure the future payment of income.[63]

One of the factors explored by the Seventh Circuit was the payment of interest by Indianapolis Power & Light. The court began by observing that, historically, advance payments of income had been included in income upon receipt because the recipient was entitled to use the

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54. *Id.* at 976-77.
55. *Id.* at 977.
56. *Id.* at 978.
57. *Id.*
58. Indianapolis Power & Light Co. v. Commissioner, 857 F.2d 1162 (7th Cir. 1988), *cert. granted*, 109 S. Ct. 1929 (1989).
59. *Id.* at 1164-65.
60. *Id.* at 1167.
61. *Id.*
62. *Id.*
63. *Id.* at 1170.

payment as its own.[64] The court then divided a recipient's "use" of a prepayment into two categories: use of the funds to earn a return and use of the funds to minimize future costs incurred on customer default.[65] While a recipient would generally enjoy benefits from both "uses," the court suggested that payment of interest on deposits would at least partially offset any benefit derived from the taxpayer's investment of the funds received, leaving the taxpayer with a deposit it could "use" only to minimize future costs incurred on customer default (*i.e.* a deposit held to secure payment of future bills).[66]

The Seventh Circuit's modification of the primary purpose test, together with its position on the significance of interest payments, had the effect of creating a second category of tax-free deposits: interest-bearing deposits held as security for the future payment of utility bills.[67] The court justified its creation of this additional class of deposits by distinguishing deposits on which the holder pays interest from the typical advance payment; only the latter could be invested and bring a return without diminution through the payment of interest.[68] According to the court, this difference justified tax-free treatment for deposits on which interest was paid.[69]

The Seventh Circuit's review of the facts in *Indianapolis Power & Light* prompted it to conclude that the company held deposits received from customers primarily as security and that, therefore, these deposits should be treated as nontaxable security deposits.[70] The court based its conclusion primarily on the company's payment of interest on deposits and on the fact that customers retained control over the timing and manner of deposit refunds.[71]

Although the Seventh and Eleventh Circuits agree that use of the primary purpose test is appropriate in characterizing a deposit received by a utility company, a dispute remains over how to classify such a deposit when the utility holds it primarily to secure the future payment of an item of income. In *City Gas*, the Eleventh Circuit held that only deposits held to secure property against damage or held to secure nonincome-producing covenants would receive tax-free treatment.[72]

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64. *Id.* at 1168 (citing Astor Holding Co. v. Commissioner, 135 F.2d 47 (5th Cir. 1943)).
65. *Id.*
66. *Id.* at 1168-69.
67. *See id.* at 1169.
68. *See id.*
69. *Id.* at 1169.
70. *Id.* at 1170.
71. *Id.*
72. *See supra* text accompanying notes 28-38.

The Seventh Circuit rejected this narrow approach in *Indianapolis Power & Light* and instead chose to evaluate the facts and circumstances of each case and, when appropriate, permit the exclusion from gross income of deposits held primarily to secure income items.[73]

As these cases were the first to address the tax treatment of deposits received by utility companies, the Tax Court and both circuit courts were forced to rely on a body of case law dealing with deposits made by tenants in connection with the leasing of property. Consequently, an analysis of the decisions in *City Gas* and *Indianapolis Power & Light* must begin with a review of these landlord-tenant cases.

B. *The Rental Deposit Cases*

One of the first cases to consider a deposit held as security for the payment of rent was *Clinton Hotel Realty Corp. v. Commissioner.*[74] The taxpayer in *Clinton* received a deposit equal to one year's rent which he agreed to hold during the lease term to ensure the payment of rent and the performance of all lease covenants by the lessee.[75] These lease covenants included a requirement that the lessee maintain the premises in good condition and that all personal property damaged by the lessee be repaired or replaced.[76] According to the lease, the landlord would apply the deposit toward payment of the last year's rent if the lessee were not in default at that time.[77] The lease required the taxpayer to pay interest on the deposit each year.[78]

The Fifth Circuit recognized that the lessee's payment could be either a taxable advance payment of rent or a nontaxable security deposit.[79] For the payment to constitute a security deposit, the court required that the payment be made and received as security and that

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73. *See supra* text accompanying notes 58-71.

74. 128 F.2d 968 (5th Cir. 1942). Earlier cases permitted exclusion of deposits from income, but in those cases, the recipient was not permitted to apply the funds received in payment of future rent. *See, e.g.*, Warren Serv. Corp. v. Commissioner, 110 F.2d 723, 724 (2d Cir. 1940) (discussed *infra* at notes 89-92 and accompanying text); Estate of Barker v. Commissioner, 13 B.T.A. 562, 567-68 (1928).

75. *Clinton*, 128 F.2d at 969.

76. *Id.*

77. *Id.*

78. *Id.*

79. *Id.* Although earlier cases considered the tax treatment of rental deposits, see *supra* note 74, none stated the alternative tests as succinctly as the Fifth Circuit in *Clinton*. In fact, the courts continue to use this basic test. The Eleventh Circuit made the only significant modification, drawing a distinction between income and nonincome items in *City Gas*. *See supra* text accompanying note 32.

the recipient have no right or claim of ownership to the sums deposited.[80] The Fifth Circuit noted that it would be appropriate to treat the payment as a security deposit even though the landlord might eventually apply the deposit to the lessee's future rent obligation.[81] The court reviewed the lease agreement to ascertain the intentions of the parties with regard to the purpose of the deposit and concluded that the parties intended the lessee's deposit to be a nontaxable security deposit.[82] Two facts influenced the court's conclusion: the taxpayer's payment of interest on the funds deposited and the possible application of the deposit to many things other than rent.[83]

One year later, the Fifth Circuit reached a contrary conclusion in *Astor Holding Co. v. Commissioner*.[84] In *Astor Holding Co.*, the taxpayer received $17,500 from the lessee at the inception of the lease "as part payment of the tenth year's rent."[85] The lease did not require the taxpayer to pay interest on the money received, nor did it indicate whether the lessor held the money to ensure the payment of rent or the performance of lease covenants.[86] The court again reviewed the lease agreement to determine the intended purpose of the payment and concluded that language in the lease characterizing the payment as prepaid rent, together with the absence of factors relied on by the court in *Clinton*,[87] justified treatment of the money received as advance rent taxable on receipt.[88]

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80. *Clinton*, 128 F.2d at 969.

81. *Id.* (citing Warren Serv. Corp. v. Commissioner, 110 F.2d 723, 724 (2d Cir. 1940); Estate of Barker v. Commissioner, 13 B.T.A. 562, 568 (1928)). However, in those cases, deposits could be applied to unpaid rent only in the event of default by the lessee. Thus, the Fifth Circuit's conclusion in *Clinton* is much more than a mere restatement of the law.

82. *Id.* at 969-70.

83. *See id.* at 970.

84. 135 F.2d 47 (5th Cir. 1943).

85. *Id.* at 48.

86. *Id.*

87. *See supra* text accompanying note 83.

88. *Astor Holding Co.*, 135 F.2d at 48. While the *Clinton* court was not troubled by the anticipated application of the deposit to the lessee's future rent obligation, the *Astor Holding Co.* court may have been concerned by such an application, given its failure to include in its statement of the law the following reference from *Clinton*: "[I]f . . . paid and received as security, with no present right or claim of full ownership, it would not be presently income, *although it was expected finally to be applied in payment of the last year's rent if nothing happened to prevent.*" *Clinton*, 128 F.2d at 969 (emphasis added); *see also supra* note 81 and accompanying text (for a discussion of the anticipated application of a deposit to future rent in *Clinton*). The absence of this language in the *Astor Holding Co.* opinion, while arguably unnecessary due to the facts of the case, apparently led the Second Circuit to conclude that the Fifth Circuit no longer subscribed to the rule announced in *Clinton*. *See* Hirsch Improvement Co. v. Commissioner, 143 F.2d 912, 915 (2d Cir. 1944) (discussed *infra* at notes 93-100 and accompanying text), *cert. denied*, 323 U.S. 750 (1945).

The approach taken by the Second Circuit in early rental deposit cases differed from that of the Fifth Circuit, but the results were essentially the same. In *Warren Service Corp. v. Commissioner*,[89] the lessee offered a refundable deposit equal to the last year's rent as security for the lessee's performance of all obligations under the lease.[90] The lease did not permit the landlord to apply the deposit in payment of the last year's rent.[91] The Second Circuit characterized the deposit as a nontaxable security deposit because of the taxpayer's binding obligation to refund the deposit at the conclusion of the lease.[92]

The Second Circuit again focused on the existence of an obligation to repay in *Hirsch Improvement Co. v. Commissioner*.[93] The taxpayer in *Hirsch Improvement* held a deposit as security for the payment of rent and the performance of lease covenants.[94] The lease agreement required the lessor to apply the deposit in payment of the last year's rent if the tenant was not then in default.[95] Noting that the lease agreement required a refund of the deposit only in the event the leased premises were condemned or destroyed,[96] the court held the deposit taxable in the year of receipt.[97] The court reasoned that "the sum received was to be repaid, in whole or part, under circumstances which might never occur and of a kind so limited as to be insufficient to require that sum to be categorized as primarily not intended as rent."[98] Rather than disagreeing with the Fifth Circuit's decision in *Clinton*, which held for the taxpayer on similar facts, the court suggested that the Fifth Circuit had qualified the *Clinton* decision in *Astor Holding Co.*[99] and likened the facts and result in *Hirsch Improvement* to those found in *Astor Holding Co.*.[100]

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89. 110 F.2d 723 (2d Cir. 1940).
90. *Id.* at 724.
91. *Id.*
92. *Id.* at 724.
93. 143 F.2d 912 (2d Cir. 1944), *cert. denied*, 323 U.S. 750 (1945).
94. *Id.* at 913.
95. *Id.*
96. *Id.*
97. *Id.* at 915.
98. *Id.*
99. Although the *Astor Holding Co.* court restated the test previously announced in *Clinton*, *see supra* note 88, a change in the Fifth Circuit's approach was not needed; the extreme facts found in *Astor Holding Co.* were enough to distinguish it from the result in *Clinton*. Consequently, the Second Circuit's approach in *Hirsch Improvement* was more an attempt to develop an independent standard than it was an acceptance of the Fifth Circuit's view in *Clinton* and *Astor Holding Co.*
100. *Hirsch Improvement*, 143 F.2d at 915.

The Tax Court first considered the tax treatment of rental deposits in *Gilken v. Commissioner*.[101] The taxpayer in *Gilken* received a sum of money as a nonrefundable deposit to secure the performance of a tenant's lease obligations.[102] The lease required the landlord to apply the deposit to the last year's rent unless the lessee exercised its option to purchase the property, in which case the landlord would apply the deposit to the purchase price of the property.[103] In determining whether the deposit was an advance payment of rent or a nontaxable security deposit, the Tax Court chose to focus on the primary purpose of the payment.[104] Relying on repeated references in the lease to the deposit as "prepaid rent" and on the absence of an obligation to refund the deposit, the Tax Court held that the parties intended the deposit to act primarily as a prepayment of rent.[105] Based on this conclusion, the court required the taxpayer to include the full amount of the deposit in income in the year of receipt.[106] The presence of an option to purchase did not alter the court's decision.[107] Rather, the court assigned secondary importance to the tenant's option to purchase and likened it to contingencies found in earlier cases[108] that other courts had held insufficient to support a binding obligation to repay.[109]

Four years after its decision in *Gilken*, the Tax Court again considered the tax treatment of a tenant's rental deposit in *Mantell v. Commissioner*.[110] The taxpayer held the deposit collected from the lessee in *Mantell* as security for the lessee's performance of all lease covenants.[111] The lease did not require the taxpayer to pay interest on the deposited funds or to place the deposit in a separate account.[112] Of particular importance was a provision in the agreement prohibiting

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101. 10 T.C. 445 (1948), *aff'd*, 176 F.2d 141 (6th Cir. 1949).
102. *Id.* at 446-47.
103. *Id.*
104. *Id.* at 453-54.
105. *See id.* at 453.
106. *Id.* at 453.
107. *Id.* at 456.
108. *Id.* at 452 (citing Hirsch Improvement Co. v. Commissioner, 143 F.2d 912, 915 (2d Cir. 1944), *cert. denied*, 323 U.S. 750 (1945); DeGolia v. Commissioner, 40 B.T.A. 845, 848 (1939)).
109. *Id.* at 456. The Sixth Circuit affirmed the Tax Court's decision in *Gilken* by applying the claim-of-right doctrine. *See* Gilken v. Commissioner, 176 F.2d 141 (6th Cir. 1949). For a discussion of the claim-of-right doctrine and its application to deposit cases, see *infra* notes 181-89 and accompanying text.
110. 17 T.C. 1143 (1952).
111. *Id.* at 1145.
112. *Id.*

the lessor from applying the deposit against unpaid rent.[113] The Tax Court applied the primary purpose test announced in *Gilken* and held that the presence of a binding obligation to refund the deposit, together with the prohibition against use of the funds to satisfy unpaid rent, justified its decision to permit exclusion of the deposit from gross income.[114]

Finally, in *J & E Enterprises v. Commissioner*,[115] the Tax Court considered a situation in which a rental deposit secured only the lessee's obligation to pay rent.[116] Instead of applying the primary purpose test, the court reviewed all the facts and circumstances surrounding the taxpayer's receipt of the deposit.[117] The court observed that the taxpayer had exclusive control over the manner in which the deposit was either refunded or applied to rent and that the deposit only secured the payment of rent and property taxes.[118] These factors convinced the Tax Court that the parties intended the deposit to act as a prepayment of rent, and the court required the taxpayer to include the funds received in income.[119]

While the conclusions reached in these rental deposit cases do not adequately respond to the issues raised in *City Gas* and *Indianapolis Power & Light*, they do provide a general framework within which to evaluate deposits. The outer boundaries of this framework are established by *Astor Holding Co.*[120] (which requires immediate taxation of

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113. *See id.* at 1145-46.

114. *Id.* at 1148. The Commissioner argued that the deposit was actually prepaid rent because deposit repayments coincided in time and amount with the lessee's obligation to pay rent during the last months of the lease term. *Id.* The court rejected this argument:

> We are, of course, aware of the relationship in time and amount between the deposit repayment installments and the rent installments for the final period. However, we cannot conclude therefrom as does the respondent that the provision for the repayment of the security deposit to the lessees lacked substance and was in fact a provision for the prepayment of rent. Such an express provision cannot easily be disregarded when, as here, the legal rights of the parties, and of third parties also, may be substantially different depending on whether the clause provides that the deposit is to be returned to the lessees or applied to the rent of the final period.

Id.

115. 26 T.C.M. (CCH) 944 (1967).

116. *Id.* at 945. The agreement permitted the landlord to pay delinquent property taxes and to increase rent due by a like amount. Thus, the deposit actually secured the payment of rent and property taxes. *Id.*

117. *Id.* at 946.

118. *Id.*

119. *Id.*

120. Astor Holding Co. v. Commissioner, 135 F.2d 47 (5th Cir. 1943).

deposits offered as prepaid rent) and by *Warren Service*[121] and *Mantell*[122] (both of which permit tax-free receipt of those deposits not available for application against future rent). Courts characterize deposits which fall between these two extremes (for example, those securing both the future payment of rent and the performance of lease covenants) by looking to either the primary purpose of the deposit[123] or the existence of a binding obligation to repay.[124]

Should the courts focus on the taxpayer's obligation to repay or the purpose of the deposit? The decisions of the Tax Court and the circuit courts in *City Gas* and *Indianapolis Power & Light* offer no clear answer. The following discussion examines the theories developed by each of the courts in these two cases in an effort to explain why the courts are unable to agree on how customer deposits should be treated for tax purposes.

III. An Evaluation of the Primary Purpose and Facts and Circumstances Tests

The decisions in *City Gas* and *Indianapolis Power & Light* fail to adequately resolve the controversy surrounding the tax treatment of utility customer deposits. Both the Tax Court and the Seventh Circuit have criticized the Eleventh Circuit's primary purpose test as a method which will always require inclusion in income of deposits held to secure income items.[125] In response, the Eleventh Circuit has suggested that the Tax Court's facts and circumstances approach relies on a number of factors which should play no role in determining whether payments received are properly included in gross income.[126] Finally, the alternative offered by the Seventh Circuit may place too much reliance on the payment of interest.[127]

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121. Warren Serv. Corp. v. Commissioner, 110 F.2d 723 (2d Cir. 1940).

122. Mantell v. Commissioner, 17 T.C. 1143 (1952).

123. Gilken v. Commissioner, 10 T.C. 445, 454 (1948), *aff'd*, 176 F.2d 141 (6th Cir. 1949).

124. *See* Hirsch Improvement Co. v. Commissioner, 143 F.2d 912, 915 (2d Cir. 1944), *cert. denied*, 323 U.S. 750 (1945); *cf.* Clinton Hotel Realty Corp. v. Commissioner, 128 F.2d 968, 969 (5th Cir. 1942) (deposit received subject to binding obligation to account for its ultimate disposition treated as tax-free security deposit).

125. *See infra* text accompanying notes 144-50.

126. *See supra* notes 33-35 and accompanying text.

127. In its petition for writ of certiorari, the Government noted that the Seventh Circuit's "heavy reliance on the payment of interest is at odds with the Eleventh Circuit's analysis, since that court in *City Gas* had stated that the payment of interest is of little importance in this context." Government's Petition for Writ of Certiorari at 11, Commissioner v. Indianapolis Power & Light Co., 857 F.2d 1162 (7th Cir. 1988), *cert. granted*, 109 S. Ct. 1929 (1989) (No. 88-1319) (citing City Gas Co. v. Commissioner, 689 F.2d 943, 948 n.7 (11th Cir. 1982)).

While none of these methods adequately resolve the problem, all have redeeming features which might contribute to the development of an alternative approach. Consequently, an analysis of the methods of characterization that the courts used in *City Gas* and *Indianapolis Power & Light* should begin any search for an acceptable method of classifying customer deposits for federal income tax purposes.

A. *The Primary Purpose Test*

The primary purpose test, as applied by the Eleventh Circuit in *City Gas*, distinguishes between deposits held as security for the future payment of income items and those held to secure the performance of nonincome-producing covenants.[128] This test treats the former as taxable advance payments and characterizes the latter as tax-free security.[129] Should an item be characterized for tax purposes based solely on its apparent purpose? An examination of the cases in which courts have used the primary purpose test provides the basis upon which this approach may be evaluated.

The Tax Court developed the primary purpose test in *Gilken*.[130] The *Gilken* court faced facts similar to those found in prior rental deposit cases, but it chose not to apply the reasoning announced in those cases and instead developed a test that characterized the funds received based on their primary purpose.[131]

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128. *City Gas Co.*, 689 F.2d at 948.

129. *See id.* at 945-46.

130. *See* Gilken v. Commissioner, 10 T.C. 445 (1948), *aff'd*, 176 F.2d 141 (6th Cir. 1949). For a review of the facts in *Gilken*, see *supra* text accompanying notes 101-09.

131. The *Gilken* court began by noting that it was faced with a factual situation not unlike those encountered by the *Hirsch Improvement* and *DeGolia* courts. Using these two cases as a starting point, the *Gilken* court began by summarizing its understanding of the existing rule:

> [E]ven though money paid upon the making of a lease is to be held for security for the performance of the conditions of the lease, if it is also provided that the payment should be applied as rent for the final period of the lease, and the circumstances under which it was to be repaid might never occur, or there was no provision for repayment to the lessee, then it is to be considered as income when received.

Gilken, 10 T.C. at 452. Without explanation, the court chose not to apply this test. Instead, it focused on the primary purpose of the deposit in an attempt to properly characterize the deposit received as either prepaid rent or tax-free security. *See id.* at 453.

Why the *Gilken* court developed the primary purpose test is unclear. Perhaps the unique facts in *Gilken* — a security deposit which could be applied to future rent or to the purchase price of the property upon exercise of a purchase option — prompted the court to design a rule that would allow it to isolate the primary purpose and characterize the deposit accordingly. This does not explain why the court applied the test again in *Mantell*, an ordinary refundable deposit case, but it does shed some light on the court's subsequent refusal to apply the primary purpose test in rental and utility deposit cases not involving purchase options.

The Tax Court's use of this approach was short-lived. After applying the primary purpose test again in *Mantell*,[132] the court abandoned the test in *J & E Enterprises* in favor of a method that characterizes the funds received based on a review of all the facts and circumstances.[133] It was not until the Eleventh Circuit had occasion to consider this issue in *City Gas* that a court again invoked the primary purpose test to require taxation of deposits on receipt.

The Eleventh Circuit created an opportunity to apply the primary purpose test in *City Gas* when it concluded that "where a taxpayer receives an advance payment for goods or services or other income items over which the taxpayer has a present right and complete and unrestricted control, the advance payment constitutes income."[134] After holding that the "present right"[135] and "complete and unrestricted control"[136] requirements had been met, the Eleventh Circuit turned its attention to the purpose of the deposit. In so doing, the court formulated its own version of the primary purpose test: "[I]f the *primary* purpose of the payment is to act as a prepayment for goods and services, then the amount constitutes taxable income; but if the *primary* purpose is to secure performance of nonincome-producing covenants or to secure against damage to property, then the payment is not taxable."[137] When the court restated this test later in the opinion, it replaced the reference to "prepayment for goods and services" with "prepayment of income items."[138] The distinction that the court drew between income and nonincome items effectively created two categories within which any deposit must fall[139] and, as subsequently

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132. Mantell v. Commissioner, 17 T.C. 1143 (1952) (discussed *supra* at note 110-14 and accompanying text). The Tax Court also applied the primary purpose test in Kitchin v. Commissioner, 22 T.C.M. (CCH) 1738, 1744 (1963), *rev'd*, 340 F.2d 895 (4th Cir. 1965).

133. J & E Enters. v. Commissioner, 26 T.C.M. (CCH) 944 (1967). The facts and circumstances approach used by the *J & E Enters.* court was basically the same as the test originally described but not adopted by the Tax Court in *Gilken*. *See Gilken*, 10 T.C. at 452 (discussed *supra* at note 131).

134. City Gas Co. v. Commissioner, 689 F.2d 943, 945 (11th Cir. 1982), *rev'g* 74 T.C. 386 (1980).

135. *Id.* at 946 nn.4 & 10. For a discussion of this portion of the Eleventh Circuit's decision in *City Gas* see *supra* note 31. *But cf. City Gas*, 74 T.C. at 395 ("Unlike a landlord receiving advance rentals under a long-term lease, petitioners have no present right to a fixed future payment.").

136. *City Gas Co.*, 689 F.2d at 946. ("[I]t is undisputed that taxpayers have unrestricted control over the sums deposited.).

137. *Id.*

138. *Id.* at 948.

139. As the Tax Court noted on remand, "[t]he Eleventh Circuit, as we understand it, did not admit of the possibility of other categories." *City Gas*, 47 T.C.M. (CCH) 971, 973 (1984).

recognized by the Seventh Circuit in *Indianapolis Power & Light*, resulted in a test which requires immediate taxation of all deposits held to secure income items.[140]

The Eleventh Circuit cited a number of rental deposit cases in support of its use of the primary purpose test in *City Gas*.[141] The court properly noted that, while some of these decisions did not specifically mention the primary purpose test, all evaluated the facts and circumstances surrounding the receipt of the deposit in question in an attempt to determine the underlying purpose of the payment.[142] Unfortunately, the court failed to justify its decision to differentiate between income and nonincome items,[143] and it is this departure from prior law

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140. *See* Indianapolis Power & Light Co. v. Commissioner, 857 F.2d 1162, 1166 (7th Cir. 1988), *cert. granted*, 109 S. Ct. 1929 (1989). The Seventh Circuit's conclusion is supported by the way in which the Tax Court applied the primary purpose test on remand in *City Gas*. *See City Gas*, 47 T.C.M. at 971 (discussed *supra* at notes 36-38 and accompanying text).

141. *See City Gas Co.*, 689 F.2d at 946-47 (citing Hirsch Improvement Co. v. Commissioner, 143 F.2d 912, 915 (2d Cir. 1944), *cert. denied*, 323 U.S. 750 (1945); Mantell v. Commissioner, 17 T.C. 1143, 1148 (1952); Gilken v. Commissioner, 10 T.C. 445, 454 (1948), *aff'd*, 176 F.2d 141 (6th Cir. 1949)). The court also cited a revenue ruling in support of its position. *See id.* at 946 (citing Rev. Rul. 72-519, 1972-2 C.B. 32).

Noting that the Eleventh Circuit had adopted all decisions rendered by the old Fifth Circuit, the court also cited three Fifth Circuit decisions, Clinton Hotel Realty Corp. v. Commissioner, 128 F.2d 968 (5th Cir. 1942); Astor Holding Co. v. Commissioner, 135 F.2d 47 (5th Cir. 1943); and Van Wagoner v. United States, 368 F.2d 95 (5th Cir. 1966), in support of its use of the primary purpose test. *City Gas Co.*, 689 F.2d at 946-47. None of these cases endorse the Eleventh Circuit's more limited position. In fact, the *Clinton* court *permitted* the taxpayer to exclude a deposit from income even though it was held in part as security for the future payment of rent and would be applied to the lessee's rent obligation in the absence of default. *See supra* text accompanying note 81. Consequently, the Eleventh Circuit's modification of existing law represents its response to a unique situation involving a deposit offered as security for the payment of future utility bills.

142. *City Gas Co.*, 689 F.2d at 946-47.

143. However, the Eleventh Circuit did illustrate the difference between taxable advance payments and nontaxable security deposits through the use of examples. The court concluded that a taxable advance payment is "a sum paid to a lessor at the beginning of a lease which is to be applied to the rent for a subsequent period, such as the final month or year of the leasehold . . .," while use of a nontaxable security deposit involves "a lessor [who] requires a lessee to deposit a sum to secure against damage to the rented premises and agrees to refund the deposit in full if no such damage occurs." *Id.* at 946.

The court did not reach a conclusion on the tax treatment of sums held as security for the payment of income items. Instead, the court remanded the case to the Tax Court with the following instructions:

> If on remand the Tax Court concludes that the primary intent was that the sums at issue be applied to discharge income items on the final bill (e.g., charges for gas, turn-on and turn-off and other service charges), the fact that the sums were labeled as "deposits to secure payment" cannot by itself preclude a finding that

which undoubtedly has created much of the concern expressed by the Tax Court and Seventh Circuit in *Indianapolis Power & Light.*

Although the Seventh Circuit subsequently adopted the primary purpose test in *Indianapolis Power & Light*,[144] the Tax Court continues to resist such a move. In *Indianapolis Power & Light*, the Tax Court acknowledged the attention that prior courts had given to a deposit's purpose, but insisted that in those cases the courts placed particular emphasis on other factors such as taxpayer control over the funds received and the obligation to pay interest.[145] Consequently, the Tax Court views "purpose" as merely one of a number of factors to be considered in connection with the characterization of customer deposits for tax purposes.

The Tax Court's reluctance to apply the primary purpose test may be based on a concern first noted by the court on remand in *City Gas*[146] and later highlighted by the Seventh Circuit in *Indianapolis Power & Light*: as used by the Eleventh Circuit in *City Gas*, the primary purpose test will always treat deposits held as security for the future payment of income items as taxable advance payments.[147]

> the sums were intended as prepayments. Although several courts have mentioned the "security" label as one factor, . . . we have found no case which would support a finding for the taxpayer where sums labeled as a "deposit" or "security" were subject to the unrestricted control of a taxpayer with a present right thereto and were intended to be applied against income items. The case law requiring a finding for the Commissioner under such circumstances . . . is based, we think, upon the unarticulated rationale that under such circumstances the sums are in substance prepayments.

Id. at 948 n.7 (citations omitted). On remand, the Tax Court cited this language in support of its conclusion that the Eleventh Circuit had recognized only two categories — taxable advance payment and nontaxable security deposit — and that a deposit must fall into one or the other. *City Gas*, 47 T.C.M. (CCH) at 973 n.4.

144. Indianapolis Power & Light Co. v. Commissioner, 857 F.2d 1162, 1167 (7th Cir. 1988), *cert. granted*, 109 S. Ct. 1929 (1989). In adopting the Eleventh Circuit's approach, the Seventh Circuit said,

> [a]lthough we believe that the proper approach to determining the appropriate tax treatment of a customer deposit is to look at the primary purpose of the deposit based on all the facts and circumstances, we conclude that the application of this test does not require a finding that a deposit to secure an income payment must always be taxed as an advance payment.

Id.

145. *Id.* at 976.

146. *See also supra* note 38.

147. *Indianapolis Power & Light*, 857 F.2d at 1166. The Seventh Circuit made some observations about the approach taken by the Eleventh Circuit in *City Gas*:

> In stating the test in this manner, the Eleventh Circuit implicitly assumed that a deposit to secure the payment of an income item is the same as the prepayment

In blurring the distinction between prepaid income and deposits held to secure income items, the Eleventh Circuit effectively prevented the evaluation of other factors on which the Tax Court had relied in deposit cases to justify its conclusions.[148]

The alternative offered by the Seventh Circuit in *Indianapolis Power & Light*, which focuses both on the purpose of the deposit and on the obligation to pay interest, provides a more flexible method of characterizing customer deposits for tax purposes. However, it is unlikely that this modification of the primary purpose test will be enough to obtain the Tax Court's endorsement. That court has taken the position that the payment of interest, while important, is not determinative in classifications of deposits for tax purposes.[149] Consequently, the Tax Court will continue to evaluate all relevant facts and circumstances when characterizing customer deposits for tax purposes.[150]

> of that income item. Under this test, a sum given primarily to secure the performance of an income producing covenant is taxed as an advance payment. Underlying this view is the recognition that in terms of the recipient's cash flow, deposits to secure income items and advance payments are essentially the same.

Id. at 1166 (citations omitted).

The court agreed with the Commissioner that the basic difference between the prepayment of an income item and the posting of a deposit to secure future payment of that item — the obligation to refund the deposit — should not necessarily control the result obtained for tax purposes. However, it did not agree that ignoring the existence of the obligation to repay explained the difference in treatment proposed by the Commissioner for deposits securing income items and those securing property. The court explained that

> [b]y overlooking the lessor's legal obligations and focusing on "the economic substance of the transaction," . . . the IRS fails in our view to persuasively explain why deposits to secure income should be treated differently from deposits to secure property that are given in conjunction with a contractual arrangement that generates an income stream (which the IRS concedes should not be included in a taxpayer's gross income upon receipt). A lessor who requires a deposit to secure against damage to leased property also has use of the deposit amount during the lease term. If no damage occurs, the money is returned to the lessee . . . . If the property is damaged by the lessee, the deposit is applied to the cost of repairs. In either case, however, the lessor holds the sum, usually with total discretion as to its use, during the period the property is in the lessee's possession. In terms of cash flow to the lessor, a deposit to secure property is at least as advantageous as a deposit to secure the payment of rent.

Id. at 1167 n.9.

148. For a discussion of the factors evaluated by the Tax Court when characterizing utility customer deposits, see *infra* text accompanying notes 151-75.

149. *City Gas*, 74 T.C. at 392 n.7 (1980).

150. The Supreme Court's decision in *Indianapolis Power & Light* may not require a change in the Tax Court's approach to security deposits. The Seventh Circuit's adoption of the primary purpose test arguably resolved the dispute between circuits over which test to use. In the

B. *The Facts and Circumstances Test*

Most courts which have addressed the tax treatment of deposits have based their decisions on a review of the facts and circumstances surrounding the taxpayer's receipt of funds. Indeed, many of the current guidelines used by the Tax Court in evaluating utility customer deposits come from early rental deposit cases. In these cases, the courts have considered factors such as the payment of interest and taxpayer control over ultimate disposition of the deposit when characterizing a deposit as either taxable income or tax-free security.[151]

Initially, the Tax Court refused to engage in a review of all the relevant facts and circumstances in determining the tax treatment of rental deposits. Instead, it decided *Gilken* by applying a new test which focused on the intended purpose of the deposit. The Tax Court later abandoned this "primary purpose test" in favor of a facts and circumstances approach, a move which has allowed the court to concentrate on those facts unique to utility companies in determining the tax consequences associated with the receipt of utility customer deposits. In *City Gas*, for example, the Tax Court used this approach to highlight the importance of the taxpayer's repayment obligation and to treat the purpose of the deposit as merely one factor to be considered when courts evaluate the taxpayer's ability to control the ultimate disposition of the deposit.[152] Similarly, in *Indianapolis Power & Light* the court used this method to emphasize the significance of the small percentage of customers required to make deposits.[153] In light of the Eleventh Circuit's adoption of the primary purpose test

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absence of such a dispute, the Supreme Court need not choose between the two tests when it considers the government's appeal in *Indianapolis Power & Light*.

Because other circuits have yet to pass on this issue, future tax court cases appealable to circuits other than the Seventh and Eleventh likely will be decided by applying the Tax Court's facts and circumstances test, while the primary purpose test will be used in cases appealable to the Seventh or Eleventh Circuits in compliance with the Tax Court's decision in Golsen v. Commissioner, 54 T.C. 742 (1970), *aff'd on other grounds*, 445 F.2d 985 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971). *Compare* American Tel. & Tel. v. Commissioner, 55 T.C.M. (CCH) 16 (1988) (facts and circumstances test used in case appealable to the Second Circuit) *with* Gas Light Co. v. Commissioner, 51 T.C.M. (CCH) 685 (1986) (primary purpose test applied in case appealable to the Eleventh Circuit).

151. The Tax Court has repeatedly emphasized these two factors when characterizing a deposit for tax purposes. For example, in *Indianapolis Power & Light*, it observed that "[w]here the taxpayer has virtually unrestricted control over the amount deposited and does not pay interest on such amount, the amount has been considered an advance payment of income." *Indianapolis Power & Light*, 88 T.C. at 976.

152. *City Gas*, 74 T.C. at 394.

153. *Indianapolis Power & Light*, 88 T.C. at 976-77.

in *City Gas* and the conclusions reached by the Tax Court on remand,[154] it seems clear that these peculiar factors — all of which strongly suggest that the funds received remain the property of the depositor — would play no role in the classification process administered by a court using the primary purpose test.[155]

When characterizing deposits for tax purposes, the courts have considered a number of factors. Some of the more significant or controversial deserve special attention.

1. Interest

The obligation to pay interest on deposits, much like a borrower's duty to pay interest on a loan, strengthens the case for an underlying obligation to repay. For this reason, the decisions in many of the early rental deposit cases hinged on the presence or absence of an obligation to pay interest.[156] In more recent cases, however, some courts have

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154. In *City Gas*, the Tax Court made the following conclusions on remand:

> The most significant item by far on most customers' final bills was the charge for gas consumed, and a deposit was typically applied as a credit against that charge. Charges for damage to meters and other nonincome items did not make up a significant portion of the total final charges. The only reasonable inference is that the deposits received from customers when service was begun were expected and intended in most cases to be applied eventually to the charges for gas consumed. Because that was the primary purpose of the deposits, they were, under the standard enunciated by the Eleventh Circuit, taxable income.

City Gas Co. v. Commissioner, 47 T.C.M. (CCH) 971, 973 (1984). In *Indianapolis Power & Light*, deposits were often refunded after creditworthiness was established. Consequently, the approach mandated by the Eleventh Circuit in *City Gas* and followed by the Tax Court on remand, as set forth above, would have yielded a different result if the *Indianapolis Power & Light* court had concluded that deposits were "typically" applied as a credit against customers' final bills. Presumably, the percentage of total deposits refunded prior to termination of service would have influenced the conclusion the court reached on this issue.

155. The Eleventh Circuit actually described the primary purpose test as a test which evaluates the purpose of a deposit based on all the circumstances. *City Gas Co.*, 689 F.2d at 948. In practice, however, the test identifies "purpose" as the most important factor. For example, in Gas Light Co. v. Commissioner, 51 T.C.M. (CCH) 685 (1986), the Tax Court characterized customer deposits as prepaid income based on their primary purpose, even though other factors, including the percentage of customers required to post deposits and the short time period within which deposits were required to be refunded, suggested a different result.

156. *See, e.g.*, Astor Holding Co. v. Commissioner, 135 F.2d 47 (5th Cir. 1943) (noninterest-bearing deposits held taxable); Clinton Hotel Realty Corp. v. Commissioner, 128 F.2d 968 (5th Cir. 1942) (interest-bearing deposits held nontaxable). Although the payment of interest was a significant factor in many of these cases, it did not assure tax-free treatment. For example, in United States v. Williams, 395 F.2d 508 (5th Cir. 1968), the court treated deposits as taxable advance payments even though interest was paid on the money deposited. *Id.* at 511; *see also*

questioned the significance of interest payments. In *City Gas*, both the Tax Court and the Eleventh Circuit placed little emphasis on the taxpayer's obligation to pay interest.[157] The Seventh Circuit took a far different approach in *Indianapolis Power & Light* when it focused exclusively on the payment of interest and its effect on the taxpayer's use of the funds received.[158] Although historically the government has treated interest as one of many factors warranting consideration,[159] the emphasis placed on interest payments in *Indianapolis Power & Light* has prompted the Commissioner to challenge the relevance of interest payments by suggesting that interest is merely "compensation for the advance payment of income items."[160]

2. Consistent Treatment for Tax and Accounting Purposes

The taxpayers in *City Gas* and *Indianapolis Power & Light* were required to treat customer deposits as current liabilities for financial reporting purposes. The Tax Court's conclusion in each case was influenced by the manner in which the taxpayers had classified deposits for accounting purposes.[161] The Eleventh Circuit criticized this approach during its review of *City Gas* by properly noting that although

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Commissioner v. Lyon, 97 F.2d 70 (9th Cir. 1938). Similarly, the presence of an obligation to pay interest was not required in one case for a decision favoring the exclusion of deposits from income. *See* Growers Credit Corp. v. Commissioner, 33 T.C. 981, 997 (1960).

157. While the Tax Court treated the payment of interest by City Gas as a "positive factor," it indicated that the nonpayment of interest by City Gas subsidiaries was not a dispositive factor requiring inclusion of deposits in income. *City Gas*, 74 T.C. at 392 n.7. On appeal, the Eleventh Circuit agreed that payment of interest was an insignificant factor:

> [W]hile the payment of interest might have significance under some circumstances, we doubt the importance of interest payments in this case. Although some courts have said that payment of interest is a factor suggestive of a nontaxable deposit, other courts have recognized that interest may reflect compensation for the advance payment of income items as well. Therefore, the Tax Court properly placed little emphasis on whether or not interest was paid in this case.

City Gas Co., 689 F.2d at 948 n.7 (citations omitted).

158. *See Indianapolis Power & Light*, 857 F.2d at 1168. The court's decision to focus on the taxpayer's use of the funds received by dividing "use" into two parts — use for investment purposes and use as security — places particular emphasis on the payment of interest. *See id.* The result reached in *Indianapolis Power & Light* suggests that the payment of a reasonable rate of interest on customer deposits will all but eliminate the taxpayer's ability to "use" the deposit as anything other than security and will thereby ensure tax-free treatment. *See id.* at 1168-69.

159. *See* Rev. Rul. 72-519, 1972-2 C.B. 32.

160. Government's Petition for Writ of Certiorari at 13, Commissioner v. Indianapolis Power & Light Co., 857 F.2d 1162 (7th Cir. 1988), *cert. granted*, 109 S. Ct. 1929 (1989) (No. 88-1319).

161. *See Indianapolis Power & Light*, 88 T.C. at 978; *City Gas*, 74 T.C. at 392.

a taxpayer is free to select any approved method of accounting for tax purposes, the method selected must clearly reflect income.[162] The Eleventh Circuit's approach undoubtedly influenced the Tax Court's decision to place little emphasis on this factor in its *Indianapolis Power & Light* opinion. However, subsequently decided Tax Court cases indicate that the court has not yet abandoned its focus on the treatment that deposits receive for financial reporting purposes.[163]

3. Obligation to Account for Deposit

Until recently, courts treated the existence of an obligation to repay as adequate justification for excluding deposits from income.[164] Many rental deposit cases were decided based on the presence or absence of a binding refund obligation; the courts reasoned that such an obligation should receive treatment similar to that enjoyed by the proceeds of a loan.[165] Although the Tax Court extended this line of reasoning to utility deposit cases in *City Gas* and *Indianapolis Power & Light* by emphasizing the existence of repayment obligations,[166] it failed to discuss a more fundamental issue: whether the taxpayer's agreement to repay represented a bona fide obligation worthy of the treatment received. This question is explored in the final part of this article.

4. Unrestricted Use and Control

Recipients have had unrestricted use of deposited funds in all utility and rental deposit cases considered by the courts,[167] but the level of

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162. *City Gas Co.*, 689 F.2d at 949 (citing Commissioner v. Idaho Power Co., 418 U.S. 1, 15 (1974)); *see also* I.R.C. § 446(b) (1986); Treas. Reg. § 1.446-1(a)(2) (as amended in 1987).

163. *See* Oak Indus. v. Commissioner, 52 T.C.M. (CCH) 1556, 1561 (1987) (treatment of deposits as prepaid income for financial accounting purposes held relevant to determination of primary purpose of deposits). *Compare* American Tel. & Tel. Co. v. Commissioner, 55 T.C.M. (CCH) 16, 21 (1988) (regulatory and financial accounting practices held relevant to a determination of the tax treatment of customer deposits) *with* Gas Light Co. v. Commissioner, 51 T.C.M. (CCH) 685, 691 (1986) (relevance of accounting practices rejected in case appealable to the Eleventh Circuit, given the circuit court's earlier rejection of the same theory in *City Gas*).

164. *See* Warren Serv. Corp. v. Commissioner, 110 F.2d 723, 724 (2d Cir. 1940); Mantell v. Commissioner, 17 T.C. 1143, 1148 (1952); *cf.* Hirsch Improvement Co. v. Commissioner, 143 F.2d 912 (2d Cir.) (existence of contingent repayment obligation insufficient to support tax-free treatment), *cert. denied*, 323 U.S. 750 (1944).

165. *See, e.g.*, Clinton Hotel Realty Corp. v. Commissioner, 128 F.2d 968, 970 (5th Cir. 1942).

166. *See Indianapolis Power & Light*, 88 T.C. at 978; *City Gas*, 74 T.C. at 392-93.

167. As the Second Circuit recognized in *Hirsch Improvement*, deposits are not taxable on receipt if they are received subject to a requirement that they be segregated from the recipient's general funds. *Hirsch Improvement*, 143 F.2d at 915. The courts have not speculated on the

control exercisable over deposits has varied. Without explanation, most courts have taken the position that unrestricted control over the ultimate disposition of deposits justifies immediate taxation.[168] While the Tax Court used this line of reasoning in *J & E Enterprises*,[169] it found ways to avoid its application in *City Gas* and *Indianapolis Power & Light*,[170] presumably because other factors suggested a different result. Thus, the extent to which courts will rely on taxpayer control when determining the tax consequences of a deposit remains unclear.[171]

5. Other Factors

The courts also have used other factors, including the ultimate escheat of unclaimed deposits,[172] the relationship between deposits and the obligation to pay rent,[173] and the percentage of customers required to make deposits,[174] as a means of classifying deposits for tax purposes. However, no combination of factors has proven a safe harbor for taxpayers who seek to exclude deposits from income.[175]

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effect of a similar restriction on use, but presumably deposits subject to such a restriction would receive similar treatment — the recipient's lack of complete control would justify exclusion from income. *See, e.g.*, *Oak Indus.*, 52 T.C.M. at 1562 (suggesting that state regulations restricting use of customer deposits influenced the Tax Court's decision in *City Gas*).

168. *See, e.g.*, Van Wagoner v. United States, 368 F.2d 95, 97 (5th Cir. 1966); Astor Holding Co. v. Commissioner, 135 F.2d 47, 48 (5th Cir. 1943); *Oak Indus.*, 52 T.C.M. at 1562; *see also* J & E Enters. v. Commissioner, 26 T.C.M. (CCH) 944 (1967) (taxpayer's exclusive control over method of repayment a significant factor); *cf.* American Tel. & Tel. Co. v. Commissioner, 55 T.C.M. (CCH) 16, 20 (1988) ("The fact that the customer retained significant control over when and how the money . . . was refunded . . . indicates that the money was not an advance payment of income.").

169. *See J & E Enters.*, 26 T.C.M. at 945-46.

170. In *City Gas*, the Tax Court relied on the taxpayers' unconditional obligation to repay and the eventual escheat of unclaimed deposits to the state to support its conclusion that City Gas and its subsidiaries did not have unrestricted control over deposits received. *City Gas*, 74 T.C. at 394. The *Indianapolis Power & Light* court reached a similar result by holding that the taxpayer could only control the disposition of a deposit when the customer failed to pay its utility bills. *See Indianapolis Power & Light*, 88 T.C. at 977.

171. Control over the ultimate disposition of deposits is a factor considered in characterizations of other deposits as well. For example, the Internal Revenue Service has ruled that deposits held by a funeral home were actually the property of its customers, given the control retained by customers over ultimate disposition of the deposits. *See* Rev. Rul. 87-127, 1987-2 C.B. 157.

172. *See Indianapolis Power & Light*, 88 T.C. at 977; *City Gas*, 74 T.C. at 392-93.

173. *See supra* note 114.

174. *See* American Tel. & Tel. Co. v. Commissioner, 55 T.C.M. (CCH) 16, 17 (1988) (six percent of all customers required to make deposits); *Indianapolis Power & Light*, 88 T.C. at 966 (five percent of all customers required to post deposits); *cf.* Gas Light Co. v. Commissioner, 51 T.C.M. 685, 686 (1986) (customer deposits treated as prepaid income even though only two-fifths of all customers were required to make deposits).

175. One court has suggested that segregation of deposits from the recipient's other funds will ensure tax-free treatment, at least for as long as the funds are segregated. *See* Hirsch

In its most recent attack on the Tax Court's facts and circumstances test, the government suggests that this approach "introduces uncertainty into the treatment of customer utility deposits" and "is much too amorphous and imprecise to provide an acceptable level of predictability for tax planning."[176] While there is some truth in these statements, they do not justify rejection of a test which has a proven record of success and offers a more comprehensive approach to the characterization of deposits held as security for the future payment of income.[177]

IV. Alternative Approaches and a Proposed Solution

Section 61 of the Internal Revenue Code requires each taxpayer to include in gross income all income from whatever source derived. Gross income for any given year includes advance payments of income,[178] but does not include security deposits received.[179] Should the courts treat a "deposit" that secures the future payment of an income

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Improvement Co. v. Commissioner, 143 F.2d 912, 915 (2d Cir. 1944), *cert. denied*, 323 U.S. 750 (1944). The courts have held that the claim-of-right doctrine may not be used to characterize funds held in formal escrow or other restrictive accounts as income since they do not represent income "held" under claim of right. *See, e.g.*, Mutual Tel. Co. v. United States, 204 F.2d 160, 161 (9th Cir. 1953). This reasoning suggests that customer deposits which are segregated from other funds and are restricted as to use should receive similar treatment.

The courts have suggested that any initial characterization of receipts in this manner would not prevent a subsequent change in circumstances from triggering taxation of funds previously characterized as tax-free. *See, e.g.*, Astor Holding Co. v. Commissioner, 135 F.2d 47, 48 (5th Cir. 1943) ("If an amount is deposited with a lessor merely as security for the performance of covenants, . . . it is not treated as taxable income *unless and until* something happens to make the deposit, or a portion of it, the property of the lessor.") (emphasis added); *accord* Gilken v. Commissioner, 10 T.C. 445, 451 (1948), *aff'd*, 176 F.2d 141 (6th Cir. 1949); *see also* Boyce v. Commissioner, 405 F.2d 526, 530-31 (Ct. Cl. 1968) (removal of condemnation proceeds from escrow triggered taxation).

176. Government's Petition for Writ of Certiorari at 13-14, Commissioner v. Indianapolis Power & Light Co., 857 F.2d 1162 (7th Cir. 1988), *cert. granted*, 109 S. Ct. 1929 (1989) (No. 88-1319).

177. Interestingly, the courts also have adopted a facts and circumstances approach to the characterization of loans for tax purposes. *See, e.g.*, John Kelly Co. v. Commissioner, 326 U.S. 521, 526 (1946); Haber v. Commissioner, 52 T.C. 255, 266 (1969), *aff'd per curiam*, 422 F.2d 198 (5th Cir. 1970). Because the existence of an obligation to repay is essential to the tax-free characterization of both loans and deposits, use of the facts and circumstances approach in loan cases offers support for application of the test in deposit cases.

178. *See, e.g.*, Schlude v. Commissioner, 372 U.S. 128 (1963); American Auto. Ass'n v. United States, 367 U.S. 687 (1961); Automobile Club v. Commissioner, 353 U.S. 180 (1957). The Treasury regulations specifically require gross income to reflect the receipt of prepaid rents. *See* Treas. Reg. § 1.61-8(b) (as amended 1957).

179. *See, e.g.*, Mantell v. Commissioner, 17 T.C. 1143 (1952).

item as a taxable advance payment[180] or a nontaxable security deposit? The following discussion examines alternative theories and concludes with a proposal for future treatment of deposits which secure income items.

A. *Claim-of-Right Doctrine*

Utility and rental deposit cases typically involve a taxpayer that receives cash pursuant to an agreement that places no restriction on the taxpayer's use of the funds received. Thus, it is not surprising that the claim-of-right doctrine, a theory developed in response to the unrestricted use of funds received, would be considered as a method of characterizing deposits for tax purposes.

The Supreme Court developed the claim-of-right doctrine in *North American Oil v. Burnet*[181] as a means of determining when taxpayers should recognize income for tax purposes.[182] The Supreme Court summarized the rule with this frequently quoted language:

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.[183]

Although the Court used the claim-of-right doctrine in *North American Oil* to identify the taxable year in which the taxpayer should report income received, commentators have suggested that the doctrine also may be viewed as a method for determining whether an amount received is income.[184] Although the doctrine was used for this purpose

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180. The Supreme Court cases dealing with the question of prepaid income, see *supra* note 178, did not consider the receipt of funds subject to an obligation to repay. Consequently, reliance on this line of cases to support the immediate inclusion of customer deposits in income would be misplaced.

181. 286 U.S. 417 (1931).

182. For a general discussion of the claim-of-right doctrine, see Dubroff, *The Claim of Right Doctrine*, 40 TAX L. REV. 729 (1985).

183. *North American Oil*, 286 U.S. at 424.

184. *See* B. BITTKER & L. LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES & GIFTS ¶ 6.3.1, at 6-12 (2d ed. 1989) (suggesting that the court's decision in *North American Oil* necessarily determined the character of the funds received because it required inclusion of the amounts in income in an earlier year despite the fact that pending litigation might require a complete refund of the funds in a later year); *cf.* S. GERTZMAN, FEDERAL TAX ACCOUNTING ¶ 12.03[2][a] (1988) (concluding that the claim-of-right doctrine is only applicable if the funds received are income).

in a series of early rental deposit cases,[185] more recent decisions suggest that the courts have yet to agree on whether it is appropriate to invoke the claim-of-right doctrine in deposit cases.[186]

As noted in many of these cases, a taxpayer must claim the amounts received as its own to have income under claim of right.[187] Taxpayers seeking tax-free treatment for deposits make no such claim. Rather, they contend that deposits received remain the property of the payor and are held temporarily to secure the performance of covenants set forth in the agreement between the parties. Because the holder of deposits does not make the requisite claim of ownership,[188] the claim-of-right doctrine should not be used as a method of characterizing deposits for tax purposes.[189]

B. *Deposits and the Obligation to Repay*

Money or other property received by a taxpayer subject to an

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185. *See* Commissioner v. Lyon, 97 F.2d 70, 73 (9th Cir. 1938); Renwick v. United States, 87 F.2d 123, 124-25 (7th Cir. 1937); United States v. Boston & P. R.R., 37 F.2d 670, 672 (1st Cir. 1930).

186. *Compare* Gilken v. Commissioner, 176 F.2d 141, 144 (6th Cir. 1949) (use of the claim-of-right doctrine justified since the funds received were not required to be segregated and were not subject to restrictions on use) *and* Boyce v. Commissioner, 405 F.2d 526, 531 (Ct. Cl. 1968) (claim-of-right doctrine used to include appealable condemnation award in income of cash-basis taxpayer on receipt) *with* Clinton Hotel Realty Corp. v. Commissioner, 128 F.2d 968, 969 (5th Cir. 1942) (doctrine had no application because taxpayer made no claim of ownership to the deposits received) *and* Growers Credit Corp. v. Commissioner, 33 T.C. 981, 998 (1960) (requisite claim of ownership not made by taxpayer).

187. *See Clinton*, 128 F.2d at 969; *Growers Credit*, 33 T.C. at 998; *see also* United States v. Merrill, 211 F.2d 297 (9th Cir. 1954) (taxpayer who renounces all rights in funds upon receipt and acknowledges an obligation to repay is not required to include such funds in gross income under claim of right).

188. But what standard does a court apply to the utility company which receives a deposit subject to an agreement to apply it to the customer's final bill? Although the company does not *claim* to have an interest in the deposit received, it clearly has some interest since the customer is likely to have a balance due upon termination of service. It is unclear in this situation whether the company's inability to determine its interest in the deposit upon receipt will prevent the claim-of-right doctrine from triggering income. For a discussion of the nature of the interest obtained by the recipient of a deposit held to secure payment of customers' future bills, see *infra* notes 216-32 and accompanying text.

189. One group of commentators has suggested that, in characterizing of deposits for tax purposes, the focus should be on two categories of deposits: advance payments and nontaxable security deposits. Once a deposit is classified as an advance payment, fundamental principles of tax accounting control recognition of the income for tax purposes. Therefore, application of the claim-of-right doctrine would not be required. *See* Burke & Friel, *Tax-Free Security: Reflections on Indianapolis Power & Light*, 12 REV. TAX'N OF INDIVIDUALS 157, 168 n.57 (1988).

obligation to repay[190] is not included in the taxpayer's gross income.[191] This treatment is consistent with the Supreme Court's notion of gross income as any "accession to wealth";[192] a taxpayer receiving assets subject to an obligation to repay realizes no increase in net assets and, therefore, has no accession to wealth.[193]

Not all obligations to repay are recognized for federal income tax purposes. The courts generally agree that a liability must be "an existing, unconditional, and legally enforceable obligation for the payment of a principal sum" to be respected for tax purposes.[194] An obligation to refund a customer deposit, like any other liability, will be respected for tax purposes if it meets these requirements.

Historically, courts have used a facts and circumstances approach when determining whether a true debtor-creditor relationship exists.[195] Although use of such a test requires the consideration of a number of factors,[196] likelihood of repayment is one of the most important.[197]

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190. Courts also have cited the obligation to expend funds in a manner which will not benefit the taxpayer as justification for the exclusion of receipts from income. *See, e.g.*, Illinois Power Co. v. Commissioner, 792 F.2d 683 (7th Cir. 1986) (funds received subject to the control of Illinois Utility Commission not taxable); Angelus Funeral Home v. Commissioner, 47 T.C. 391 (1967) (funds collected from prospective customers and held in trust not income); Seven-Up Co. v. Commissioner, 14 T.C. 965, 979 (1950) (taxpayer was a conduit for monies pooled by distributors to purchase national advertising; identity of funds not destroyed by commingling funds with the taxpayer's general funds); *Cf.* Iowa S. Util. Co. v. United States, 11 Cl. Ct. 868 (1987) (power surcharge received from ratepayers subject to refund obligation held income on receipt because refunds were to be made to all current ratepayers, not just those who were ratepayers when the surcharge was assessed).

191. Commissioner v. Tufts, 461 U.S. 300, 319 (1983) (O'Connor, J., concurring).

192. *See* Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430 (1955).

193. *See generally* B. BITTKER & L. LOKKEN, *supra* note 184, ¶ 6.1, at 6-2 (money or other property received subject to an obligation to repay does not enrich the recipient and therefore does not constitute gross income); Popkin, *The Taxation of Borrowing*, 56 IND. L.J. 43, 46-48 (1980) (discussing the taxation of money or other property received subject to an obligation to repay).

194. Dri-Power Distribs. Ass'n Trust v. Commissioner, 54 T.C. 460, 478 (1970); *see also* First Nat'l Co. v. Commissioner, 289 F.2d 861 (6th Cir. 1961); Autenreith v. Commissioner, 115 F.2d 856 (3d Cir. 1940). For a discussion of the possible significance of the method of repayment, see *infra* notes 209-10 and accompanying text.

195. *See, e.g.*, John Kelly Co. v. Commissioner, 326 U.S. 521 (1946); Haber v. Commissioner, 52 T.C. 255 (1969), *aff'd per curiam*, 422 F.2d 198 (5th Cir. 1970).

196. In a recent case, the Tax Court observed that "[a]mong the factors which have often been applied are: (1) whether there is a fixed date for repayment; (2) whether there is a reasonable expectation of repayment; (3) whether there are notes or other evidences of indebtedness; (4) whether interest is required; (5) whether the creditor makes a demand for payment once the debtor is in default." Bain v. Commissioner, 57 T.C.M. (CCH) 800, 802 (1989).

197. *See* Illinois Power Co. v. Commissioner, 792 F.2d 683, 690 (7th Cir. 1986) ("usually the court just asks how likely is repayment, and if the answer is, not very, the receipt is treated

The Second Circuit acknowledged the critical importance of the likelihood of repayment when it treated rental deposits received by the taxpayer in *Warren Service* as tax-free security due to the existence of a binding obligation to repay.[198] Using the same reasoning, the Second Circuit reached the opposite conclusion in *Hirsch Improvement* by noting that the rental deposit "was to be repaid under circumstances which might never occur. . . ."[199] While decisions in other rental deposit cases appear to place little emphasis on the likelihood of repayment,[200] courts have based such decisions[201] on the presence or absence of factors frequently considered by courts when determining whether a debtor-creditor relationship exists.[202] Thus, likelihood of repayment is a factor courts should evaluate and rely upon to properly characterize deposits for tax purposes.[203]

Of course, the existence of an obligation to repay should not be based solely on the likelihood of repayment.[204] When characterizing deposits for tax purposes, the courts have relied on other factors,

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as income."); *see also* Hirsch Improvement Co. v. Commissioner, 143 F.2d 912, 915 (2d Cir. 1944), *cert. denied*, 323 U.S. 750 (1945) (presence of contingencies suggested that repayment was not likely).

198. Warren Serv. Corp. v. Commissioner, 110 F.2d 723, 724 (2d Cir. 1940).

199. *Hirsch Improvement*, 143 F.2d at 915.

200. *See, e.g.*, J & E Enters. v. Commissioner, 26 T.C.M. (CCH) 944 (1967); Mantell v. Commissioner, 17 T.C. 1143 (1952); Gilken v. Commissioner, 10 T.C. 445 (1948), *aff'd*, 176 F.2d 141 (6th Cir. 1949).

201. The presence of other facts in some rental deposit cases made an evaluation of the likelihood of repayment unnecessary. *See, e.g.*, Astor Holding Co. v. Commissioner, 135 F.2d 47 (5th Cir. 1943); *Mantell*, 17 T.C. at 1143.

202. *See, e.g.*, Clinton Hotel Realty Corp. v. Commissioner, 128 F.2d 968 (5th Cir. 1942) (court focused on the presence of an obligation to pay interest and the variety of items secured by the deposit, both of which support the likelihood of repayment). In *J & E Enters.* and *City Gas*, however, taxpayer control over ultimate disposition of the deposit determined the character of the funds received. *See* City Gas Co. v. Commissioner, 74 T.C. at 394; *J & E Enters.*, 26 T.C.M. at 946. Query whether the recipient's ability to decide whether to refund a deposit or apply it in payment of a receivable due from the customer should dictate the character of the deposit. For a discussion of this issue, see *supra* notes 167-71 and accompanying text.

203. Likelihood of repayment is established by the presence of an unconditional obligation to repay. *See, e.g.*, Warren Serv. Corp. v. Commissioner, 110 F.2d 723, 724 (2d Cir. 1940); *Mantell*, 10 T.C. at 1148. This likelihood of repayment test is not met, however, if there is no provision for refund, *see Astor Holding Co.*, 135 F.2d at 48; *J & E Enters.*, 26 T.C.M. at 946; *Gilken*, 10 T.C. at 453; August v. Commissioner, 10 T.C. 1165, 1166 (1952), or if deposit refunds are conditioned on events which may not occur. *See* Hirsch Improvement Co. v. Commissioner, 143 F.2d 912, 915 (2d Cir. 1944), *cert. denied*, 323 U.S. 750 (1945).

204. The Seventh Circuit agreed with this position in *Indianapolis Power & Light. See supra* note 147.

including control over the ultimate disposition of the funds received,[205] the existence of an obligation to pay interest,[206] and the length of time during which the recipient is entitled to hold the funds.[207] Because the significance of any one factor may be outweighed by others suggesting a different result, an evaluation of all relevant facts and circumstances is necessary to properly determine the existence of an unconditional obligation to repay.[208]

Once the taxpayer establishes that a repayment obligation exists, a more difficult question is encountered: Will the method of repayment affect the tax treatment of the deposit? This problem arises whenever a deposit agreement permits the recipient to apply the deposit against a customer's future bills. From the customer's standpoint, there is no economic difference between a cash refund and a refund made through a reduction in the customer's bill. Similarly, the recipient realizes no taxable economic benefit since exercise of its right to offset merely facilitates payment without the incurrence of collection costs.[209] Thus,

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205. *See supra* notes 167-71 and accompanying text.

206. *See supra* notes 156-60 and accompanying text.

207. The fact that customer deposits would be repaid within a fixed and relatively short period of time suggested to the Tax Court in *Indianapolis Power & Light* that the deposits were received subject to an unconditional obligation to repay. *See* Indianapolis Power & Light Co. v. Commissioner, 88 T.C. 964, 968, 977 (1987), *aff'd*, 857 F.2d 1162 (7th Cir. 1988), *cert. granted*, 109 S. Ct. 1929 (1989). The Tax Court reached a similar conclusion in American Tel. & Tel. Co. v. Commissioner, 55 T.C.M. (CCH) 16, 17 (1988). *Cf.* Gas Light Co. v. Commissioner, 51 T.C.M. (CCH) 685, 689 (1986) (deposits treated as taxable advance payments despite the fact that refunds were required to be made after customers had established a record of 24 months of prompt payments). Interestingly, the Tax Court in *City Gas* was not bothered by the fact that the taxpayer held customer deposits for an indeterminate period ending with the termination of service. *See* City Gas Co. v. Commissioner, 74 T.C. 386, 388 (1980), *rev'd*, 689 F.2d 943 (11th Cir. 1982). The *Indianapolis Power & Light* court's reliance on the fixed holding period suggests that likelihood of repayment may not be enough to shelter deposits from income if the recipient is entitled to hold the deposits for an indeterminate period of time. *See Indianapolis Power & Light*, 88 T.C. at 977.

208. *Cf.* Covey v. Commissioner, 28 T.C.M. (CCH) 1379, 1385 (1969) (citing Ambassador Apts. v. Commissioner, 50 T.C. 236, 241 (1968), *aff'd per curiam*, 406 F.2d 288 (2d Cir. 1969) in support of its reliance on all facts and circumstances when characterizing a note as a bona fide debt for purposes of the deduction for interest); Dixie Daires Corp. v. Commissioner, 74 T.C. 476, 493 (1980) (characterization of corporate advances as either loans or contributions to capital should be made by reference to all the evidence); Rev. Rul. 79-229, 1979-2 C.B. 210, 211 (facts and circumstances approach used to characterize expenditure as either deposit or deductible expense).

209. *See Indianapolis Power & Light*, 857 F.2d at 1169 ("The deposit merely assures that IPL [Indianapolis Power & Light] will be paid and minimizes the collection costs IPL would otherwise incur if the depositor defaults, functions typically associated with security deposits.").

the manner in which the taxpayer may refund a deposit should not influence the deposit's characterization as a tax-free obligation to repay.[210]

Is proof of a binding obligation to repay enough to shelter customer deposits from taxation? In most situations, an unconditional obligation to refund a customer deposit will prevent it from being taxed. However, as discussed below, the receipt of deposits held as security for the future payment of income items may provide the recipient with an economic benefit that should be taxed notwithstanding the existence of a binding obligation to repay.

C. *Economic-Benefit Doctrine*

As noted above, the concept of gross income is grounded on the principle of "accession to wealth."[211] The receipt of a deposit subject to an unconditional obligation to repay ordinarily does not result in an accession to wealth. However, it has been suggested that a utility company that holds such a deposit to ensure payment of future bills receives an economic benefit that in many cases should be treated as an accession to wealth for purposes of the income tax.

A utility company that receives a deposit as security for the payment of future utility bills has the use of the customer's money for as long as the account remains active. Additionally, the company is assured that the customer's final bill will be paid because it may either withhold the deposit refund until the customer makes payment or apply the deposit to the final bill. The current receipt of money, together with the guaranteed receipt of income in the future, is argu-

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210. *See* American Tel. & Tel. v. Commissioner, 55 T.C.M. (CCH) 16, 21 (1988) (court concluded that taxpayer merely exercised right of setoff to avoid expense of writing additional checks). In *City Gas*, the taxpayers collected deposits which they could elect to apply toward payment of a customer's final bill. *City Gas*, 74 T.C. at 388-89. The Tax Court concluded that these customer deposits were unconditionally subject to refund even though the companies usually applied deposits against final bills rather than refunding them to customers upon receipt of payment. *Id.* at 390, 394. Although courts have distinguished between these two situations in the past, *see, e.g.*, Mantell v. Commissioner, 17 T.C. 1143, 1148 (1952), some argue that there is no difference between the two. *Cf.* August v. Commissioner, 17 T.C. 1165, 1169 (1952) (payment of rent and simultaneous issuance of deposit refund check collapsed by court into single transaction; deposit treated as taxable advance payment); *see generally* Burke & Friel, at 167-68 ("There seems little substantive difference between a deposit that may be applied to reduce future rents and a deposit that must be returned at once the future rent has been paid."). The Seventh Circuit rejected this "substance over form" argument in *Indianapolis Power & Light. See Indianapolis Power & Light*, 857 F.2d at 1167 n.9.

211. *See supra* text accompanying notes 192-93.

ably the same as the prepayment of that future income.[212] Both the Tax Court and the Seventh Circuit rejected this "substance over form" theory in *Indianapolis Power & Light*,[213] but the courts failed to adequately explain their reluctance to adopt this approach.[214] Consequently, the government has advanced this position in its petition for writ of certiorari to the Supreme Court.[215]

Beyond this argument of substance over form, however, lies another theory which is perhaps more fundamental in its approach. This theory suggests that the presence of an economic benefit — the current use of the funds together with the assured receipt of future income — is enough to justify current inclusion of the customer deposit in gross income. Although traditionally the concept of gross income has not focused on the receipt of an economic benefit,[216] *Reed v. Commissioner*,[217] a recent case from the First Circuit, suggests that economic benefit is an accurate means of identifying items of gross income. In that case, the court held that "an individual should be taxed on any economic benefit conferred on him to the extent that the benefit has an ascertainable fair market value."[218]

This approach, which was first advocated in a recent article,[219] would isolate deposits that secure items of income and treat them as income in the year of receipt despite the existence of a binding obligation to repay. If the customer ultimately paid the bill, the taxpayer

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212. As discussed in note 180, *supra*, Schlude v. Commissioner, 372 U.S. 128 (1963); American Auto. Ass'n v. United States, 367 U.S. 687 (1961); and Automobile Club v. Commissioner, 353 U.S. 180 (1957), the "trilogy" cited most often in support of the recognition of prepaid income, would not support this "substance over form" argument because those cases did not involve the receipt of deposits subject to an obligation to repay.

213. *See* Indianapolis Power & Light v. Commissioner, 88 T.C. 964, 976 (1987), *aff'd*, 857 F.2d 1162, 1169 (7th Cir. 1988).

214. The Tax Court rejected this theory by drawing different conclusions from the cases cited by the Commissioner. *See Indianapolis Power & Light*, 88 T.C. at 975-76. The Seventh Circuit concluded that "[a]lthough the recipient is assured that a customer's outstanding bill will be paid, this benefit alone in our view does not constitute "the use" of the proceeds in a manner sufficient to justify immediate taxation of the deposit." *Indianapolis Power & Light*, 857 F.2d at 1169.

215. Government's petition for writ of certiorari at 12, Commissioner v. Indianapolis Power & Light Co., 857 F.2d 1162 (7th Cir. 1988), *cert. granted*, 109 S. Ct. 1929 (1989) (No. 88-1319).

216. Historically, the economic-benefit doctrine has been used only to determine when deferred compensation should be included in an employee's gross income. *See* Sproull v. Commissioner, 16 T.C. 244, 247-48 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174, 179-80 (Situation 4).

217. 723 F.2d 138 (1st Cir. 1983).

218. *Id.* at 147.

219. *See* Burke & Friel, *supra* note 189, at 173-75.

would be entitled to a deduction for the amount of the deposit subsequently refunded.[220] If the taxpayer applied the deposit in payment of the customer's final bill, it would charge the customer for the unpaid balance and recognize the resulting increase in income at that time.[221]

The recipient of a deposit held to secure future income has no accession to wealth, and therefore no income, provided the deposit is received subject to a valid obligation to repay.[222] Yet this recipient appears to have improved its economic situation by enhancing its cash position and assuring the receipt of future income. If the recipient's right to apply deposits against future income is not considered a valid means of repayment as some courts have suggested,[223] the economic benefit represented by the receipt of cash and assurance of future income would constitute an accession to wealth.[224]

But exactly what benefit does the taxpayer realize in this scenario? The cash method taxpayer receives a benefit in the form of guaranteed recognition of income,[225] while the accrual-method taxpayer is assured that no future loss will be incurred if the account later proves uncollectible.[226] According to proponents of the economic-benefit doctrine,

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220. City Gas Co. v. Commissioner, 47 T.C.M. (CCH) 971, 974 (1988). However, this deduction would not trigger an adjustment under I.R.C. § 1341(a) because the deduction taken for refunds made would not have been taken with respect to an erroneous inclusion in income in an earlier year, as required by I.R.C. § 1341(a)(2) (1986).

221. This presumes the taxpayer is using the accrual method of accounting for tax purposes. *See* I.R.C. § 446(c)(2) (1986); Treas. Reg. § 1.446-1(c)(1)(ii) (as amended in 1987).

222. *See supra* note 193 and accompanying text. For example, if a $100 deposit is received subject to an obligation to return $100 in the future, the increase in assets due to the receipt of cash is offset by an increase in liabilities, and no accession to wealth has been realized. However, if the taxpayer assumes no obligation to repay, or if the obligation assumed is not respected for tax purposes, the increase in assets is not offset by an increase in liabilities, and the resulting increase in equity constitutes a taxable accession to wealth. In this situation, temporary deferral would be available under Treas. Reg. § 1.451-5(c) (as amended in 1985); Gas Light Co. v. Commissioner, 51 T.C.M. (CCH) 685, 692-93 (1986); *City Gas*, 47 T.C.M. (CCH) at 975.

223. *See, e.g.*, Hirsch Improvement Co. v. Commissioner, 143 F.2d 912, 915 (2d Cir. 1944), *cert. denied*, 323 U.S. 750 (1945); J & E Enters. v. Commissioner, 26 T.C.M. (CCH) 944, 946 (1967).

224. *Cf.* B. BITTKER & L. LOKKEN, *supra* note 184, ¶ 6.1, at 6-2 (discussed *supra* at note 193). *See also supra* note 222.

225. I.R.C. § 451(a) (1986); Treas. Reg. §§ 1.446-1(c)(1)(i) (as amended in 1987); 1.451-1(a) (as amended in 1978).

226. The receipt of cash does not ordinarily dictate when income is recognized for tax purposes under the accrual method of accounting. *See* Treas. Reg. § 1.446-1(c)(1)(ii) (as amended in 1987). Consequently, the receipt of a deposit held to secure the payment of accrued income serves only to assure the taxpayer that later collection problems will not result in the recognition of an offsetting loss.

taxpayers realizing such benefits should characterize deposits received as advance payments of income.[227]

Advance payments of income are taxable to the recipient upon receipt under both the cash and accrual methods of accounting. Taxpayers using the cash method of accounting are required to recognize all items constituting gross income in the year of receipt.[228] Advance payments are also taxed on receipt under the accrual method of accounting despite the fact that income is ordinarily recognized when earned under the all-events test.[229] However, this exception to the all-events test, which was developed by the Supreme Court in a series of cases known as the trilogy, presumes that the payments received are items of income.[230]

Unlike the advance payments made in the trilogy cases, customer deposits held to secure the receipt of income represent future income only to the extent that they assure the payment of customer bills. Since the amount of income guaranteed by each deposit cannot be determined until the customer's bill is prepared,[231] the trilogy cases

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227. *See* Burke & Friel, *supra* note 189, at 173-74.

228. Treas. Reg. § 1.446-1(c)(1)(i) (as amended in 1987).

229. The accrual method of accounting requires that all items of income be recognized in the year in which "all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy." Treas. Reg. § 1.446-1(c)(1)(ii) (as amended in 1987). The Supreme Court modified this rule in a series of cases known as the trilogy by requiring accrual method taxpayers to recognize income on receipt, even though the all-events test had not yet been met. *See* Schlude v. Commissioner, 372 U.S. 128 (1963); American Auto. Ass'n v. United States, 367 U.S. 687 (1961); Automobile Club v. Commissioner, 353 U.S. 180 (1957).

230. In each of the cases comprising the trilogy, the taxpayer received deposits which could be identified as income on receipt. In *Schlude*, the taxpayer received cash representing fees for dance lessons which could be taken by the customer on demand. Since the fees were not refundable in the event the lessons were not taken, it was clear that the payments received were income on receipt. *See Schlude*, 372 U.S. at 135-36. Similar conclusions were reached by the Court in *American Auto. Ass'n* and *Automobile Club*, both of which involved the receipt of nonrefundable club fees entitling the paying member to a variety of services upon request. *See American Auto. Ass'n*, 367 U.S. at 689-90; *Automobile Club*, 353 U.S. at 188-90. The ability to characterize receipts as income is also a prerequisite to taxation under the cash method of accounting. *See* Treas. Reg. § 1.446-1(c)(1)(i) (as amended in 1987) (requiring cash-method taxpayers to include income items in gross income on receipt).

231. This inability to identify the amount of guaranteed future income distinguishes the utility deposit cases from the rental deposit cases. The Tax Court recognized this distinction in *City Gas* when it observed that "[u]nlike a landlord receiving advance rentals under a long-term lease, petitioners have no present right to a *fixed* future payment." *City Gas*, 74 T.C. at 395 (emphasis added, citations omitted). While the right to a fixed future payment does not arise in a utility deposit setting until the amount of the customer's future bill is determined, a landlord's right to future rental payments is usually fixed at the inception of the lease. *See*,

do not support the inclusion of customer deposits in income prior to the time at which the income portion of the deposit can be identified. A similar conclusion can be drawn from the First Circuit's decision in *Reed* to limit taxation to those economic benefits having an ascertainable fair market value.[232] Because the economic benefit associated with the receipt of customer deposits held to secure future income cannot be characterized and valued on receipt, exclusive reliance on the economic benefit doctrine to characterize deposits as prepaid income is misplaced.

D. *A Proposed Solution*

Any attempt to properly classify a customer deposit for federal income tax purposes must begin with an evaluation of the relationship established between the customer and the recipient when the deposit is received. If a review of all the facts and circumstances[233] indicates that the recipient likely will refund the deposit,[234] the parties have established a debtor-creditor relationship,[235] and the deposit should qualify for the tax-free treatment to which any "loan" is entitled.[236] This approach does not, however, address the method of repayment, a factor which has led some courts to disregard an otherwise valid obligation to repay.[237] If the right to offset deposits against customers bills is not recognized as a valid means of repayment, the focus must

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e.g., J & E Enters. v. Commissioner, 26 T.C.M. (CCH) 944 (1967); Gilkin v. Commissioner, 10 T.C. 445, 451 (1948), *aff'd*, 176 F.2d 141, 145 (6th Cir. 1948). Consequently, a deposit offered to secure the payment of a fixed future obligation to pay rent results in a benefit which is subject to valuation in the year the deposit is received.

232. *See supra* text accompanying note 218.

233. *See supra* note 204-08 and accompanying text.

234. Many of the rental deposit cases did not involve deposits which were received subject to an obligation to repay. For example, in *Gilken*, the taxpayer received the rental deposit subject only to the lessor's obligation to apply it to the last year's rent in the event all other lease covenants had been performed by the lessee. *Gilken*, 10 T.C. at 446-47. The courts in Clinton Hotel Realty Corp. v. Commissioner, 128 F.2d 968 (5th Cir. 1942) and *J & E Enters.*, 26 T.C.M. (CCH) at 944 considered similar situations. However, in each of those cases the recipient of the deposit had a duty to *account* to the lessee for the ultimate disposition of the deposit. *See, e.g., Clinton*, 128 F.2d at 969. Since either manner of disposition effects the same result economically, see *supra* note 210 and accompanying text, the duty to account for the disposition of a deposit in this manner should be treated as an obligation to repay for purposes of this proposal.

235. *See supra* text accompanying notes 190-208.

236. *See supra* text accompanying notes 190-93.

237. *See supra* note 223 and accompanying text.

shift to the economic benefit realized through the receipt of deposits held to secure future income.[238]

In evaluating the economic benefit realized by the recipient of customer deposits, one must first evaluate the underlying purpose of the deposit.[239] If the deposit secures the performance of nonincome-producing covenants or secures against damage to property,[240] it does not assure the future receipt of income and, therefore, confers no taxable economic benefit on its recipient.[241] However, if the deposit secures the future payment of income items,[242] it does guarantee the receipt of future income, and taxation of the corresponding economic benefit is justified.[243]

A decision on when the recipient must include this economic benefit in gross income must then be made. Some commentators have suggested that the mere presence of an economic benefit justifies taxation of the entire deposit in the year of receipt.[244] However, this approach fails to recognize that sometimes the economic benefit is not subject to valuation until the income item the customer deposit secures becomes fixed.[245] In suggesting that realization of an economic benefit should be the basis for determining gross income, the First Circuit in *Reed* properly recognized that valuation of such benefits is a prerequisite to inclusion in income.[246] If the economic benefit associated

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238. *See supra* text accompanying notes 223-24. The significance of the right of offset as a valid means of repayment should not be confused with the existence of an obligation to repay. In the absence of an obligation to refund a customer deposit (either by refunding the deposit in cash or by offsetting some or all of the deposit against the customer's account balance) the entire deposit is treated as an advance payment of income. *See, e.g.*, Schlude v. Commissioner, 372 U.S. 128, 135-36 (1963); Hagen Advertising Displays v. Commissioner, 407 F.2d 1105, 1109-10 (6th Cir. 1969). In contrast, the right to apply deposits in payment of customer bills merely discounts the obligation to repay; only that portion of each deposit which actually assures the receipt of future income should be treated as a benefit subject to the income tax.

239. Presumably, the Eleventh Circuit's primary purpose test would be used whenever the deposit served more than one purpose. *See* City Gas Co. v. Commissioner, 689 F.2d 943, 946 (11th Cir. 1982).

240. The Eleventh Circuit was the first to distinguish between income and nonincome-producing covenants. *See City Gas Co.*, 689 F.2d at 946. For a discussion of the court's distinction between these two types of deposits, see *supra* text accompanying notes 31-32.

241. *See City Gas Co.*, 689 F.2d at 946.

242. *See supra* note 240.

243. *See supra* note 224 and accompanying text.

244. *See* Burke & Friel, *supra* note 189, at 174. Presumably, this position is based on the annual accounting concept, which requires taxable income to be computed on the basis of the taxpayer's taxable year. *See* I.R.C. § 441(a) (1986); *see also* Burnet v. Sanford & Brooks Co., 282 U.S. 359, 365-66 (1931) (income tax is assessed on income realized during the taxpayer's annual accounting period rather than on income calculated on a transaction by transaction basis).

245. *See supra* notes 231-32 and accompanying text.

246. *See* Reed v. Commissioner, 723 F.2d 138 (1st Cir. 1983).

with the receipt of a deposit cannot be valued at the time of receipt, taxation of the benefit must be postponed.

The Internal Revenue Code generally requires taxpayers to recognize all items of gross income in the year of receipt.[247] Included among the numerous exceptions to this general rule[248] is a doctrine of judicial origin that suspends taxation of consideration received until its character can be determined.[249] Cases in this area usually involve payments made in consideration for the receipt of an option to purchase property. Although the grant of an option often results in the immediate recognition of ordinary income,[250] the option holder's future action may affect the character of the funds received if the sales agreement requires the property owner to apply the option payment against the purchase price of the property upon exercise of the option.[251] Under these circumstances, the courts have held that the taxpayer may postpone recognition until a future event (lapse or exercise of the option) determines the character of the payments received.[252]

The justification for postponing recognition of income in utility deposit cases is even stronger because, unlike option payments (which represent income that cannot currently be classified), deposits received from utility customers may not be income at all. A utility cannot characterize customer deposits as either future income or refundable

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247. I.R.C. § 451(a) (1986). This provision of the Internal Revenue Code anticipates that different methods of accounting may justify recognition of receipts in a different period. *See* Treas. Reg. § 1.451-1(2) (as amended in 1985).

248. *See, e.g.*, I.R.C. §§ 1031, 1033-34; *see also* Treas. Reg. § 1.451-5(c)(1)(i) (1985); *cf.* Rev. Proc. 71-21, 1971-2 C.B. 549, 549-50.

249. *See, e.g.*, Kitchin v. Commissioner, 340 F.2d 895 (4th Cir. 1965); Virginia Iron Coal & Coke Co. v. Commissioner, 99 F.2d 919 (4th Cir. 1938), *cert. denied*, 307 U.S. 630 (1939); Dill Co. v. Commissioner, 33 T.C. 196, 200 (1959), *aff'd*, 294 F.2d 291 (3d Cir. 1961).

250. *See Virginia Iron Coal & Coke Co.*, 99 F.2d at 921 (payments received treated as taxable income rather than return of capital if option to purchase surrendered).

251. For example, in *Dill*, the taxpayer granted an unrelated company the right to use a trademark pursuant to a licensing agreement which also provided the user with an option to purchase the trademark. *Dill*, 33 T.C. at 196-97. The agreement stated that, upon exercise of the option, consideration previously paid for any extension of the license prior to purchase would be applied in reduction of the purchase price. *Id.* at 199-200. The Third Circuit agreed with the taxpayer that the monies paid for an extension of the licensing agreement could not be characterized as either ordinary income or capital gain until it was later determined whether the option to purchase would be exercised. *See id.* at 300-01.

252. *See Kitchin*, 340 F.2d at 898-99; *Dill*, 294 F.2d at 301; *Virginia Iron Coal & Coke Co.*, 99 F.2d at 921. *Cf.* Gilken v. Commissioner, 10 T.C. 445, 454 (1948) ("we think . . . [the payments] were . . . primarily intended as rent, and that the applicability upon purchase price is so secondary as not to require a different conclusion.").

security until it prepares the customer's final bill.[253] Once the utility company determines the customer's obligation, that portion of the deposit which assures payment of the obligation can be characterized as income.[254] If the deposit exceeds the amount owed by the customer, the balance would be characterized as a refundable security deposit and afforded tax-free treatment.

Consider the result obtained through the use of such an approach. In *City Gas*, receipt of customer deposits offered as security for the future payment of utility bills provided the taxpayers with an economic benefit not currently susceptible to valuation, but the Tax Court nevertheless required the taxpayers to include all such deposits in income in the year of receipt.[255] Under the approach proposed above, taxation of customer deposits would be required due to the economic benefit realized through the guarantee of future income, but the companies would be permitted to defer recognition of that benefit given their inability to identify the income portion of each deposit prior to preparation of customers' final bills. As noted above, this conclusion would be predicated on the existence of a binding obligation to repay.[256]

In *Indianapolis Power & Light*, the taxpayer realized a similar economic benefit through the receipt of customer deposits held to secure the payment of future utility bills. The obligation to account for the ultimate use of the deposit, the relatively short holding period, and other factors mentioned by the Tax Court and the Seventh Circuit[257] support the existence of an unconditional obligation to repay. Since the benefit that the taxpayer realized was not currently subject to valuation, the proposed approach would defer characterization of customer deposits until the taxpayer either refunded the deposit or applied it in payment of a particular bill.

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253. *See supra* note 231 and accompanying text. Preparation of the customer's final bill could be considered a change in circumstances warranting a reevaluation of the deposit's tax-free status, as contemplated by the courts in some of the early rental deposit cases. *See supra* note 175.

254. This assumes that the receipt of income is guaranteed either by applying the deposit to the customer's account or by retaining the deposit pending receipt of payment from the customer. *See supra* note 210.

255. *See City Gas*, 47 T.C.M. (CCH) at 973.

256. Payment of interest on deposits, the duty to account for the ultimate disposition of deposits, and escheat of all unclaimed deposits are all factors supporting the conclusion that the companies in *City Gas* established a debtor-creditor relationship with customers when deposits were collected. *See City Gas*, 74 T.C. at 392. Although deposits were held by the companies for an indeterminate length of time, it is unlikely that this factor would require a different conclusion. *See supra* note 207. In the absence of an obligation to repay, each deposit would be taxed in its entirety on receipt. *See supra* notes 178 & 180 and accompanying text.

257. For a discussion of the relevant factors relied upon by the courts, see *supra* text accompanying notes 54-71.

V. CONCLUSION

Should customer deposits be considered tax-free security or prepaid income? Although the courts initially considered this question in a series of rental deposit cases,[258] debate over the proper tax treatment of customer deposits really began with the Tax Court's decision in *City Gas*. That decision prompted the courts to reexamine the way in which deposits are characterized for tax purposes, and it eventually led to the development of a number of characterization methods, none of which adequately resolves the problem posed by a utility company's receipt of deposits held to secure future income items.

The Tax Court, when characterizing deposits for tax purposes, applies a facts and circumstances approach.[259] The Eleventh Circuit rejected this method and instead adopted a test that focuses on the primary purpose of the deposit.[260] Most recently, the Seventh Circuit endorsed an approach that evaluates both the purpose of the deposit and other relevant factors, but places particular emphasis on the obligation to pay interest.[261] Each of these methods has merit, but all fail to adequately address the underlying economic benefit realized from the receipt of a deposit held to secure future income.

The solution proposed above recognizes that deposits received as security for the future payment of customer bills provide the recipient with an economic benefit that ultimately should be included in gross income. If the recipient has an unconditional obligation to account for the disposition of the deposit, it should include in gross income that portion of the deposit which guarantees the receipt of future income, but not until the resulting economic benefit can be valued. In deferring characterization of deposits, this method ensures that the benefit eventually taxed is an accurate measure of the income actually realized by the recipient.+

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258. *See supra* text accompanying notes 74-124.
259. *See supra* note 150 and accompanying text.
260. *See supra* text accompanying note 137.
261. *See supra* text accompanying notes 58-69.

+*Editor's Note*: In a unanimous decision issued on January 9, 1990, the Supreme Court concluded that deposits received by the taxpayer in *Indianapolis Power & Light* did not constitute taxable income on receipt. The existence of an unconditional obligation to repay and customers' retention of control over the manner of repayment were cited by the Court in support of its decision.